Bank Safety & Soundness Advisor

Executive intelligence on bank exams, enforcement and risk management.

March 7, 2011

Compensation Already an Issue in Consent Orders

Regulatory interest in compensation has already gone beyond guidance and proposed new rules. Examiners have made an issue of compensation in exams and a few banks have already found language in consent orders demanding a justification for and review of bank compensation.

"Several recent orders have included references to compensation," says Pat Cole, a compensation consultant in the Grand Rapids, Mich. office of Crowe Horwath. "They involve more than just the effectiveness of top management. [The orders] ask for an explanation of how pay is determined. I'm seeing it more and more frequently."

Consider this, from an FDIC consent order issued to the First Bank and Trust Company of Illinois, Palatine, Ill., in December 2010. The regulator demanded a management plan from the company and, as part of that plan, regulators wanted a compensation review.

"Within 90 days from the effective date of this ORDER, the Board shall form a Compensation Committee that includes three outside directors to review the compensation of

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DIY Good Bank / Bad Bank: Should You Spin Your NPAs into a Non-bank Subsidiary?

The good bank / bad bank model isn't just for regulators. Banks saddled with non performing assets (NPAs) or OREOs can isolate those assets – and even keep them out of a Call Report – with a non-bank subsidiary. The model has clear workout and accounting benefits. It might even head off regulatory action. But for banks that want to take advantage, the capital requirements are steep.

More banks should be thinking about the subsidiary model for their distressed assets, argues Francis X. Grady, a partner with Grady & Associates, Cleveland, Ohio. In particular, banks should consider creating non-bank subsidiaries of their holding companies. Those that do can take those non-performing assets out of their balance sheets and Call Reports, he notes.

The regulatory benefits to the bank that pulls this off could be considerable. "A bank might have a surge in problem assets," Grady says.

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Enterprise-Wide Risk Assessment Key to Understanding Compensation Risk

When regulators ask you to justify the risk embedded in your compensation plans, they're asking you to put that risk in context, whether you realize it or not. Without understanding your firm's total risk and the place your compensation and incentive plans play within it, you won't understand the risk in those plans, let alone be able to justify them to regulators, experts say. An enterprise-wide risk monitoring program may be the only way to vet that risk and prove to examiners – as well as investors and the board – that a given bank's incentive plans fit within and forward the banks strategic plans.

As recently proposed Dodd-Frank rules on incentive-based compensation suggest, the regulators and the federal government haven't lost interest in compensation and the role it can play in triggering firm-killing risk. Under the new rules, firms over $1 billion in assets will have to convince examiners that their incentive-based compensation plans don't bring "excessive" risk to the bank (see "Dodd-Frank Incentive Rules to Rely on Nebulous Standards," *Bank Safety & Soundness Advisor*, February 28, 2011).

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Published weekly (48 times a year).

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DIY

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"If the ratio of problem assets to Tier 1 capital exceeds a certain level, it will prompt enforcement action. If a bank is forward-thinking and has a holding company [where it can move the assets], it can dodge an enforcement action."

If a bank can move its distressed assets to a holding company subsidiary, it will "clean up the balance sheet completely," adds Jeff Gerrish, an attorney with Gerrish McCreary Smith in Memphis. "If you're a $200 million bank with $20 million in distressed assets and if the holding company buys those assets at par, you'll be fine with the regulators. The Federal Reserve will look at the assets up there."

From a regulatory perspective alone, the maneuver can make a lot of sense, adds Grady. "When you set up the non-bank subsidiary, you take the problem assets out of the bank," he says. "The primary regulator cares about the level of problem assets in the bank. They're interested in protecting the fund. If the holding company has the capital to take the assets out of the bank and pay for them, then that's the way to go."

And that's the catch. If a bank wants to move distressed assets into a subsidiary of the holding company, that holding company needs the capital to accommodate the move, says Gerrish. A lot of banks are short on capital right now and if they had the opportunity to raise capital, they would have already taken advantage.

"That's a massive catch," he says. "Banks like to talk about [non-bank subsidiaries], but most don't focus on the fact that you have to raise capital to replace the assets. Clients come in and want to do the bad bank thing. [I ask them,] 'Where will you get the capital?' They say, 'What do you mean, capital?' The discussion usually ends right there."

Another potential pitfall: the accounting impact of the transfer. Banks that pursue this strategy need to be very careful about their valuations of the assets earmarked for transfer, says Brian Olasov, managing director with McKenna Long & Aldridge LLP in Atlanta, Ga.

"[Banks won't] want to trigger a write-down of assets to get the appropriate sales treatment," he says. "Depending on the sale to the separate legal entity, regulators will require that the transaction is valued as an arms-length transaction. [A transaction like this] may trigger the need to write down the value of the assets to fair market value. And examiners typically take a dimmer view of the underlying values [of those assets] than the bank will."

The challenge can be particularly acute with non-performing loans, where there's much less precision involved, Olasov adds.

"REO is more straightforward," he says. "Most banks are already complying with REO appraisal requirements and banks that aren't facing capitalization challenges have already written REO down to market clearing values. It's more of a challenge with non-performing loans. It's hard to transfer them without triggering an additional write-down, which further compromises capital."

Nevertheless, some banks have found enough capital to create their own bad bank in recent years. Some came by the necessary capital through an infusion of TARP capital, as seems to be the case with Synovus Financial Corp.

In late 2008, the company established a parent-level subsidiary, Broadway Asset Management, to hold OREO that had been acquired from Synovus's bank subsidiaries. According to the holding company's 10-K filing, the subsidiary took on $500 million in OREO assets and earmarked $150 million for liquidation. That $150 million included both impaired loans and bank-owned assets. The organization may have used TARP funds to finance the asset transfer. According to the *Atlanta Business Chronicle*, the Synovus subsidiary was, as of January 2009, funded by $970 million U.S. Treasury investment as part of the Capital Purchase Plan.

Glacier Bancorp also got into the act last year. According to its 8-K filing, the company formed a wholly-owned unit, GBCI Other Real Estate, during the second quarter of 2010 "to isolate bank foreclosed properties for legal protection and administrative purposes." During the second and third quarters, foreclosed properties were transferred to the new entity from bank units at fair market value, and such properties are held for sale. After doing so, the company moved foreclosed properties to the new entity from bank subsidiaries at fair market value.

How can a non-bank subsidiary benefit your bank?

1. An extra layer of PR protection. A subsidiary with a new name can help insulate your bank from the stigma of the bad assets, Grady says.

2. Extra liability protection. Banks typically have insurance to protect themselves against accidents that take place on the site of an OREO property, but keeping those properties in a subsidiary adds that extra layer of protection, Grady says. "It's a time honored strategy. If you're holding an asset that can potentially hurt you, you should place it in a separate entity. In the event the OREO involves a partially completed structure, isolating the property in a separately capitalized subsidiary does not expose the bank's net worth to litigation claims for accidents occurring on a construction site."

3. Better workouts. Keeping distressed assets in a subsidiary, away from the bank, can make workouts more efficient, Grady argues. Keeping those distressed assets in a separate entity helps a bank maintain clean lines of duty, he says. The workout officers strictly handle workouts with the subsidiary and loan officers stick to performing assets and new loans. "It avoids mission creep," he says.

4. A better way to sell or leverage those assets. A subsidiary can also help preserve a better market for those assets if and when you decide to sell, says Grady. "It's the same with every distressed real estate asset purchaser – when they see that a bank is selling, they think it's a fire sale and they try to beat the bank down on price," he says. "That's why, if you look at the names of most OREO/asset resolution subsidiaries, the name doesn't come from the bank. You don't want your bank's name associated with the sale of distressed assets. You might get a better price for the asset if it's not sold by 'First National Bank.'"

Segregating those REO properties in an affiliate can also put banks in a better place to strike deals, adds Olasov. There are investors and real estate operators are out there looking for properties and projects they think they can turn around, he says. It can be easier to strike mutually beneficial deals with those investors and operators if you've put all your REO into a separate investment vehicle.

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Bad Bank Pioneer: Mellon Bank

Solvent banks first started experimenting with subsidiaries as a means to isolate bad assets in the aftermath of the S&L Crisis. An early example, Mellon Bank in Pittsburgh, Pa., created a "bad bank" subsidiary, Grant Street National Bank, in the late '80s.

In a 2009 *New York Times* op ed, Max Holmes, then a young analyst working on the Mellon deal, described company's experiment like this: "While the government oversaw the transaction, the money Grant Street used to buy Mellon's troubled assets came from private investors looking for long-term profits," he wrote. "By 2005, Grant Street's liquidation was also successfully completed, at a profit."

GSNB Chairman William B. Eagleson later described the bank's experience with the model as positive, according to a Wharton study on the good bank / bad bank model. Nevertheless, he also pointed to several tricky aspects to the process that could trip up emulators, including the high cost of the process, difficult fundraising and insufficient staffing at the bad bank. ■

Consider the CAO

If you want a better view into compensation risk and how it works in practice, consider putting the chief audit officer on the job.

The CAO and the audit staff can be a very useful tool for gauging risk, says Walter Smiechewicz, chief audit executive with First Niagara Bank, ($21 billion), Lockport, N.Y. Why? Because the audit officer gets a trench-level view of a bank's business units and they maintain a measure of independence within the firm.

"The auditor needs to cut to the heart of the audit function, which is protecting the assets of the bank and the interests of the shareholder," Smiechewicz says.

Many banks have treated ERM as primarily, or entirely, a compliance function. Ideally, ERM should function as a strategic tool, he says. And if banks wanted to leverage the audit function, they could bring it along into the wider discussion about risk and strategy. "I have been encouraging my colleagues to spend more time working with and thinking about strategy and firm-wide risk and less time thinking about checking invoices," he says.

If banks want to leverage the audit staff, they'll need to hire a different kind of auditor, he adds. A hire with a background in accounting and clerical work will be better off checking invoices. If banks decided to hire MBAs as well as finance and economics students to fill audit positions, they could play an important role in the enterprise-wide risk monitoring process. ■

Compensation Risk

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Banks that don't understand their aggregate risk profile will be hard pressed to make this case to examiners, says Dan Borge, a director and risk consultant with LECG in New York, N.Y.

"You really do need ERM in a practical sense [if you want to understand compensation]," he says. "Otherwise, how do you know how much risk you're taking? If you haven't made a serious attempt to at least look at most of the business units, products and locations and then come to grips with an aggregate position [of total risk], then you have no credible position – you can't say you're not taking excessive risk."

Regulators likely won't expect banks to have bullet-proof justifications for compensation risk at your next exam, but they will want to see that you are taking steps to better understand that risk, Borge adds.

"In the regulator's mind, excessive risk is defined at the institutional level," he says. "If you can't show them that you're coming to grips with this, you'll have an unpleasant experience."

Some regulators are already pressing banks on the risk embedded in their compensation, says Marcus Faust, an ERM consultant and SVP at RP Financial, Arlington, VA. Regulators have been particularly keen on questioning banks holding TARP, he says. "They're telling banks that they need to look at the compensation risk to the entity. They view it as a way to protect TARP repayment."

Examiners aren't exempting smaller firms from compensation risk discussions, either, Faust adds. "[Regulators] certainly are looking at compensation in smaller firms, particularly those in troubled condition and those [holding] TARP," he says.

What examiners want to know is that banks are balancing incentives, he says. That they're not encouraging short term results over long term value creation, whether intentionally or not.

Compensation risk shouldn't matter only to regulators, Borge adds. Your shareholders and board should also want to know that the bank has deployed its resources efficiently and that it isn't inadvertently funneling unnecessary or hidden risk into the firm.

Compensation Risk and ERM

Vetting compensation risk should come relatively early in the ERM process, says Smiechewicz, chief audit executive with First Niagara Bank, ($21 billion), Lockport, N.Y. Ideally, the chief risk officer and even the chief audit officer should look into it as soon as the bank has completed its enterprise-wide risk assessment. Once risk officers do turn their attention to compensation, it's critical that they understand just what, exactly, the banks incentives have and will create.

"When you incent someone to do something, they'll do it," he says. "Banks need to be careful that they're not incenting employees to take on too much risk. Incentive structures can, and often do, incent employees to take on more risk than the bank's plan desires. In this case, you get what you pay for, but that isn't what you've planned for."

Once you've been through an enterprise-wide risk assessment, you can start to investigate compensation as a function of risk. There are many ways a bank can do this, suggests Borge. Here's one: compare business units based on revenue and capital-at-risk.

In a simple example, if two business units and see that they both brought in $100 million in revenue in a given year, yet one of the two was twice as risky as the other, you may want to revamp compensation in that second unit.

"Obviously, you'd question the performance and the compensation in the higher risk unit," Borge says. "They're taking on more risk to make the same revenue and that might suggest that they're not very good at their jobs or that they don't realize the risk that they're taking."

Here's another method: Zero in on the outcomes. Banks that want to know if their incentives match up with their bank-wide risk appetite and strategic goals can simply look at what they produce from the incentives they have in place, says Smiechewicz. "Look at the assets that the business units are bringing in, juxtapose that with the types of deals they're doing and then juxtapose that with the revenue stream they're bringing in," he says. "Then compare it all to the strategic plan and see how they align."

Some mismatches won't be hard to spot, he adds. A bank may think it's pursuing a relatively conservative strategy, but then the bank starts to spot complex, hybrid instruments on the balance sheet. "The reason they're there is because individuals in the bank have been incented to take that risk," he says. "The numbers tell a story. I'm a firm believer in this."

This kind of comparison can only follow from an ERM analysis, Borge adds. A basic assumption in ERM is that once you complete the analysis you've created a standard measure for risk. This allows you to compare different products or businesses to other products or businesses based on their risk profiles. "[In this way, ERM] gives you the presumption of a level playing field."

Regulators will expect regular reviews of compensation plans. This happens to be a best practice, too, notes Pat Cole, a compensation consultant in the Grand Rapids, Mich. office of Crowe Horwath. "The annual review of the plan documentation is very important," he says. "Banks need to make sure that their strategic plan priorities are represented in the compensation document."

One reason why some banks desperately need this kind of planning: They have too many compensation plans and can't track them all. A CFO of a larger bank recently asked Cole to come in and review his banks multiple compensation plans. The executive couldn't even tell Cole how many the bank had. As it turned out, the bank carried 55 separate compensation plans. "This is a best practice," Cole adds. "Banks need to know how many plans they have and put oversight for those plans under a single committee."

A lot of banks aren't very far along on this process. According to Crowe Horwath's 2010 Financial Institutions Compensation Survey only around one half of banks track and approve compensation plans. Out of 340 respondents, 52.1% said that its board did, in fact, review and approve incentive compensation plans.

Compensation risk troubles don't end once you've calibrated

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Incentive Tip: Diversify Your Metrics

A lot of banks tend to build their performance incentives around a single metric. Get us X volume! We want Y growth! A plan that uses just one performance metric lacks balance, suggest Pat Cole, a compensation consultant in the Grand Rapids, Mich. office of Crowe Horwath.

"In the past it was typical to be focused on growth or on a specific product," Cole says. "But it's much better to design a compensation plan with more than one key performance metric."

Banks that build incentive plans with a single metric might find out just what it can do to a bank's risk profile to bring in too much of a good thing. "There can be unintended consequences," Cole says. "You can have growth without profit or growth without due diligence."

And, in fact, banks can help to balance out risk in incentives by building due diligence into the incentives. Banks should incent good behavior, too, suggests Walter Smiechewicz, chief audit executive with First Niagara Bank, ($21 billion), Lockport, N.Y.

It's not a good idea to gear your incentive-based pay entirely to sales or volume metrics, he says. The bank will want those staffers to mind bank policies and refrain from bringing unnecessary risk into the firm, so why not incent that as well? Tie some percentage of incentive pay for meeting good compliance metrics, Smiechewicz says. Managers need to know that part of their incentive will be based on meeting these compliance metrics. ■

Compensation Risk

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your compensation to your risk appetite. Here are a few problems you could run into, long after your risk assessment is complete.

1. Compensation risk in acquisitions. A bank may have the right risk culture and an incentive plan that fits within that culture, but it could still run into trouble after a merger. Banks shouldn't underestimate the cost and the effort involved in transferring its risk appetite to new acquisitions, says Bart Kimmel, an ERM consultant and director in the Los Angeles office of Crowe Horwath.

"Some clients have done a stellar job with the growth of an organization and they've done great due diligence when they start to acquire other banks, but sometimes they'll end up collecting incentive plans that haven't been fully reviewed," he says. "That bank might also [inherit] new employees that have a different appreciation for the level of risk that's acceptable. You can encounter a completely different risk profile in an acquisition."

Banks that are involved in the merger market need to take a "much broader view of what risk management means," when it has to deal with a new business unit or bank subsidiary operating under a different risk philosophy.

2. The lasting impression of a high-risk culture. If a bank or a business division within a bank has a history of setting aggressive incentive targets, it may continue to set too aggressive targets after a bank has long since set risk limits, says Cole. A bank's incentive culture can have a lasting influence on risk and incentives, he says. Make sure that your bank's incentives really do fit within the bank's stated risk appetite.

A central, enterprise-wide risk function can help banks avoid this pitfall, adds Kimmel. ■

Examining Comp

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all Bank executive officers," states the order. "The Compensation Committee shall review written job descriptions, job duties, and time spent on bank affairs. The Compensation Committee shall review at least two independent compensation studies and determine a recommended level of compensation taking into consideration the Bank's asset size, financial condition, complexity of operations, and duties and responsibilities of each position. The Board shall act upon the recommendations provided by the Compensation Committee. The results of the review and the actions taken by the Board shall be forwarded to the Regional Director and Division within 120 days from the effective date of this ORDER."

On February 19th, 2010, American Enterprise Bank, in Buffalo Grove, Ill. received an FDIC consent order with the following stipulation: The bank had to provide an "evaluation of all policy making executive's compensation, including salaries, director fees, and other benefits."

Strategic Capital Bank, Champaign, Ill., faced a similar demand back in 2008. In an amended order to cease and desist, FDIC examiners demanded a management plan that not only identifies "both the type and number of officer and staff positions needed to properly manage and supervise the affairs of the bank," it also insisted that the bank provide "Prudent salary ranges for all officer positions." ■

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"There have been a lot of discussions between banks and real estate operators and those operators are saying: 'Let us make a minority investment in the subsidiary and help you reposition the real estate asset.' And depending on how successful those operators are, the bank can share in the success."

"It makes it cleaner [to do these kinds of deals] if you've moved the assets," Olasov adds. "If you're going to bring in potential operators and investors, it's much cleaner accounting to manage the investment relationship as long as the going-in values are clearly understood by all parties." ■